Introducing Islamic Banking

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What is Islamic Banking?

“Islamic Banking is interest free Asset Backed banking governed by the principles of Islamic Shariah”

The total worldwide Muslim population is about **1.57 billion or 23% of world population.**

Sharia-compliant assets, growing over the last 20 years, represent an estimated **US$ 250 billion**. Assets are held by over **200 Islamic Financial Institutions**. Estimated annual growth for Islamic Assets is estimated at **15%.** Asia has taken the lead in the Sukuk market.

Only in Malaysia, the value of outstanding Islamic corporate bonds stands at nearly **US$ 16 billion**, representing the interest in Shariah-compliant products.

The world stock of sovereign Islamic bonds raised is approximately **US$ 3 billion**. To-date Sovereign / Supra-Sovereign issuance in the Islamic Sukuk Market has been from - **Malaysia, Qatar, Islamic Development Bank, Bahrain, the German State of Saxony and Govt. of Dubai (Oct 2004).**

Islamic Banking distinguishes from Conventional Banking in four (4) basic principles:

Interest Free Transactions.
Risk Sharing
Asset & Service Backing
Contractual Certainty(Gharar free contracts)

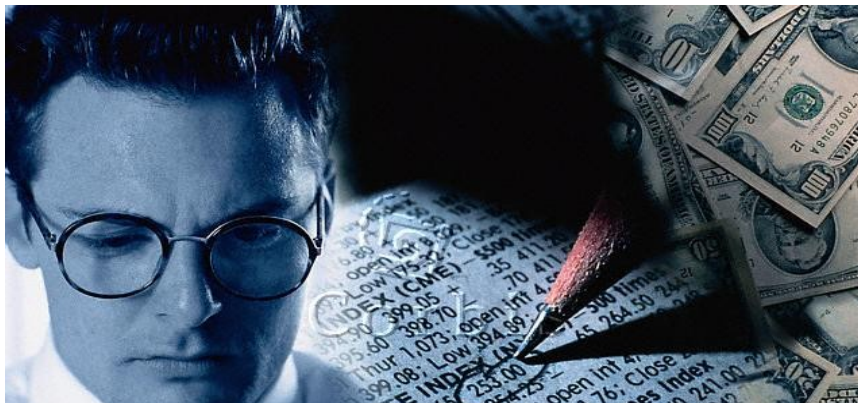
Business
Administration

Islam accepts the market forces of supply and demand- Reference of Holy Quran.

In fact Islam gave the concept of Market Forces 1300 years before Keynes presented the modern model of Economics in 1927.

Islam accepts the right to private property and accepts the right to maximize profits. But these rights are not unbridled and unconditional rather there are some prohibitions.

Flaws of Capitalism

No bindings/ restrictions while maximizing profits.
Blindly follows market forces that creates exploitation of labor & poor people.
No moral value limitations.
Monopolies & Cartels are created that exploit the society as a whole.
Government & Industrialists join hands for mutual benefit and make laws that exploit common people.
Imbalance in the distribution of income due to which concentration of wealth takes place.

Flaws of Socialism

The other extreme of not even giving the natural freedom.
Perfect Planning is assumed to be the "Cure of all ills".
Governments are assumed to be angels which can't commit a deliberate mistake.
Cannot work without forceful dictatorship.
Creates overall inefficiency in the society. There is no incentive to work efficiently as there is no individual profit motive.

Divine Prohibitions:

Islam has prohibited some economic activities that are not allowed at any time at any place.(Interest, Gambling, Hoarding etc.)

Govt. Restrictions

Islam allows Govt. to intervene where it feels appropriate , but these restrictions are temporary as per the need of the time.

Moral Considerations & Restrictions (ROIA)

Life in this world is temporary and there is an eternal life after words. One has to make this worldly life a way to get the maximum benefit in the life hereafter.

In both Capitalism & Socialism the right to wealth is with those factors of production only that have taken part directly in the process of production.

Islam believes that the original ownership of everything is with Allah and without Allah's "Taufeeq" no factor of production can produce anything.

In Islam there are three factors of production:-

1.Land 2. Labor 3. Entrepreneur

Entrepreneur & Capital is a single factor of production.

As interest is Haram hence the risk of profit & loss is with the capital.

Anyone investing capital must also take the risk of the investment.

Capitalism gives unbridled and un-conditional right to profit motive
and private ownership, while socialism goes to other extreme by
assuming that perfect planning by the govt. is the cure of all ills.

Islam gives a balance view among the two extremes by recognizing the
right to private ownership, market forces and profit motive but under
the restrictions of:

1. Divine restrictions
2. Govt. restrictions
3. Moral considerations

Islam ensures equitable distribution of wealth through the concept of
primary and secondary ownership.

All these factors combined have a cumulative effect of achieving the

International Overview

The size of Islamic Financial Industry has reached US$ 250 Bln. and its growing annually @ 15% per anum. 42 countries have Islamic Banking Institutions. 27 Muslim countries including Bahrain, UAE, Saudi Arabia, Malaysia, Brunei and Pakistan;
15 non-Muslim countries including USA, UK, Canada, Switzerland, South Africa and Australia

Leading foreign Banks have opened Islamic Banking windows or subsidiaries such as:

- Standard Chartered Bank
- Citibank
- HSBC
- ABN AMRO
- UBS

In Feb 1999, Dow Jones introduced the Dow Jones Islamic Market Index (DJIM) of 600 companies world wide whose business complies with Islamic Shariah laws

At present there are more than 105 Islamic Funds operational through out the world with a total fund base of over USD 3.50 billion.

Governments of Bahrain ,Malaysia and now Pakistan have issued Islamic Bonds (Sukuk) in order to facilitate Islamic Banks in managing their liquidity.

Issuance of these bonds has also paved the way for Shariah compliant Government borrowings.

Institutions like Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and Islamic Finance Services Board (IFSB) have been formed.

These institutions are playing a key role in setting up and standardizing Shariah , Financial and Accounting standards for Islamic Financial Institutions.

Due to these collective efforts Islamic banking is now recognized by IMF, World Bank and Basel Committee.

The current Islamic Banking movement is a Grass Root Level Demand Driven Phenomenon.

Its about time for the whole industry to pursue for the Islamic Banking Industry to reach the “Tipping Point”.

Tipping Point" is that magic moment when ideas, trends and social behaviors cross a threshold, tip and spread like wildfire.

We are, as humans, heavily socialized to make a kind of rough approximation between cause and effect.
Consider for example the paper folding example- geometric progression.

As human beings we have a hard time with this kind of progression, because the end result-the effect-seems far out of proportion of the cause.

We need to prepare ourselves for the possibility that sometimes big changes follow from small events, and that sometimes these changes can happen very quickly.

We need to understand :

What Motivates a customer towards Islamic Banking? (This includes both new & existing users of banking services)

What is modern day Marketing?

Who is Islamic Banking’s Customer?

How to market Islamic Banking to make it reach to the tipping point

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From Hazrat Abu Hurayrah (RA):

The Prophet, peace be on him, said:

"Riba has seventy segments, the least serious being equivalent to a man committing adultery with his own mother."

(Ibn Majah)

Islamic Banking- Way Ahead

KEY ACTION POINTS:

TO ENSURE CONSTANT SUPPLY OF MANPOWER TRAINED IN BOTH BANKING AND THE *SHARÎ'AH*

ESTABLISHMENT OF ISLAMIC MONEY MARKET

TAX REFORMS FOR ENSURE LEVEL PLAYING FIELD

RESOLVE *FIQHI* DISPUTES AND ADDRESS TO SHORTAGE OF RECOGNIZED & QUALIFIED SHARIAH SCHOLARS

STANDARDIZATION OF TERMS AND MODES AT A FASTER PACE

RESEARCH AND DEVELOPMENT INSTITUTIONS TO INTRODUCE INNOVATIVE PRODUCTS

Risk Issues In Islamic Banking

financial risk

some actions can protect
the same actions can destroy

To put it simply and directly,
if the bosses do not or cannot
understand both the risks and
rewards in their products, their firm
should not be in the business.

- *William J. McDonough, President,*
Federal Reserve Bank of New York

Acquisition Risk

- Different cultures between banks "consolidating"

Careless Error Risk

- Human error should be forgiven. But this is not covered by law

Competitive Risk

- LIBOR / KLIBOR / EIBOR determine competitors returns

Commodity Risk

- If you take delivery can the commodity price be managed?

Communication Risk

- Al Wadiah or Musharaka ? Sudan case
- Define terms clearly

Country Risk

- Much of Islamic banking is carried out in emerging markets. Riskier?

Credit Risk

- Not loans. Not IOUs. So equity not loan risk

Cultural Risk

- Difference between Gulf and Malaysia - Four schools in Fiqh Islam

Currency Transaction Risk

- No use of derivatives permitted. Cannot hedge exchange rate for purchases or sales

Currency Translation Risk

- Balance sheet value of dollar assets or liabilities fluctuate

Currency Economic Risk

- Hedging Proton vs Hyundai cars. Again no hedging permitted in some schools of thought

Customer Satisfaction Risk

- If a bank pays no dividends despite making profits customers will get angry

Disaster Recovery Risk

If a terrorist or earthquake strikes can you cope? Potential war zones?

Economic Activity Risk

Overheads are fixed. Post Sep 11 downturn

Energy Price Risk

Most Islamic countries’ economies are linked to the oil price

Environment Risk

Are environment unfriendly policies haram?

Equity Market Risk

Islamic banking is ideally profit and loss sharing. This is venture capital or equity investment

Fraud (banker) Risk

Transparency is required. Avoid the risk of misinterpretation

Fraud (customer) Risk

If an investor loses money will he seek redress? Of course if he wins he will not!

Fraud (staff) Risk

Haram for lenders to seek material benefit. BCCI was not an Islamic bank but fraud could occur in Islamic banks

Image / PR Risk

Something deemed hallal could be deemed haram. Sep 11 was bad PR

Information Risk

Lack of transparency in accounts in many Islamic countries. AAOFI / IAS

Inflation Risk

The securitised asset increases in value but not the repayment amount which being a cash amount depreciates

Interest rate Risk

Islamic Banking is not a closed economy. If interest rates rise sharply deposits will flow out

Interaction Risk

- Same as correlation. Sep 11 had an effect

Language Risk

- Arabic, English, Malay, Indonesian, Urdu? Same word can have different meanings.

Legal Risk

- UK, Malaysian, .. Is the bank / customer permitted to carry out such business. Ultra Vires issue

Liquidity Risk

- Major problem for Islamic banking is the absence of a developed Islamic money market.
- about managing confidence and the liability side.
- About managing diversification.

Morbidity Risk

- No different from conventional banking. What happens if there is an outbreak of dengue or Anthrax?

Mortality Risk

- Do you have offices in a tall building? Would you survive major loss through fire?

Operational Risk

Are strong procedural systems in place? Really everything other than market risks

Performance Measurement Risk

Many measures of performance are crude and slavish adherence to rules can lead to poor real performance

Political Risk

Seizure of assets post Sep 11; boycotts

Competence / Understanding

Are the latest products really understood by the banks' senior management? By the customers?

Concentration of assets Risk

A problem for Islamic funds. No tobacco, banking and alcohol stocks can lead to heavy weighting in property and technology

Concentration of liabilities Risk

Do you have enough investors or do you depend on one or two?

Concentration of business type Risk

Financial supermarket or nimble niche player are both fine. But can you reinvent yourself if markets change?

Convertibility Risk

Deliverability risk under exchange control imposition.

Property (Real Estate) Risk

Would asset backing be sufficient in times of a property crash?

Rating Agency Risk

A downgrading or even credit watch can impact on liquidity and the entire business. Investment grade bonds do not default. They become Junk and then default.

Regulatory Risk

A firm operating globally will face different rules

Religious Risk

A Hallal product may later be deemed Haram. Zero coupon bonds were once Hallal

Resignation Risk

Over dependence on one person’s skills and contacts?

Settlement Risk

If there is no escrow account there is settlement risk on Murabaha and BBA

Systemic Risk

Financial instability is contagious. Financial systems are closely inter-linked

Tax Risk

Do the sale and repurchase transactions face VAT / purchase tax? Income tax or capital gains tax treatment?

Technological Risk

Are your fax confirmations going to your customer or a competitor?

Transport Risk

Traffic jams may have led to cancelled meetings which may never be rearranged

Weather Risk

Could you hedge against the weather? KL's 1998 smog and Kuwait's burning oil fields probably had an adverse impact on employees health.
Weather derivatives are being traded but probably Haram. Weather Takaful?

Zero Risk

It’s impossible to take an unnecessary risk.
because you only find out whether a risk
was unnecessary
after you’ve taken it

Giovanni Agnelli, President FIAT

Particular Islamic banking risk issues

Liquidity – undeveloped money market
Interest rate Risk
Commodity
Equity risk – fund management or banking?
Operational risk
Religious – Hallal or Haram?
Language Risk - English, Arabic, Malay or Urdu

All transactions involving usury/interest are prohibited (*Haram*)

> 2:275 THOSE who gorge themselves on **usury** behave but as he might behave whom Satan has confounded with his touch; for they say, "Buying and selling is but a kind of **usury**" - the while God has made buying and selling lawful and **usury** unlawful. Hence, whoever becomes aware of his Sustainer's admonition, and thereupon desists [from **usury**], may keep his past gains, and it will be for God to judge him; but as for those who return to it -they are destined for the fire, therein to abide!

Islamic Banking in Malaysia

Islamic Banking Act 1983 specifically governs the Islamic banking business, the provisions of the same may not be sufficiently exhaustive to cover all aspects. Thus, there are several legislations that are refer to in the conduct of Islamic banking business.

These are:

* The Banking and Financial Institutions Act 1989 (BAFIA)
* The Takaful Act 1984
* The **Companies** Act 1965
* The Securities Commission Act
* The Stamp Duty Act 1949
* The National Land Code
* The Contracts Act 1950
* The Real Property Gains Tax Act 1967
* The Hire Purchase Act 1967
* The Sale of Goods Act 1957
* The Development Financial Institutions Act 2002

The main authority that carries out a supervisory and advisory role and at the same time ensures enforcement of rules and regulations under the BAFIA and IBA is Bank Negara Malaysia. Bank Negara Malaysia performs its functions pursuant to the powers vested unto it by the Central Bank of Malaysia Act 1958. Section 16A of the Central Bank of Malaysia Act 1958 states that Bank Negara Malaysia has the power to report suspected offences committed by any banking institution under, inter alia, the Banking and Financial Institutions Act 1989 and the Islamic Banking Act 1983. 'Banking institution' is defined under the Central Bank of Malaysia Act 1958 as 'a licensed bank, a licensed merchant bank or a licensed finance **company** as defined in the Banking and Financial Institutions Act 1989 or an Islamic bank'.

The BAFIA remains one of the core legislation on operational issues and where the IBA is silent on some issues, the provisions of BAFIA may be referred to. Section 124 of the BAFIA on Islamic banking or Islamic financial business applies to licensed institutions which conduct Islamic banking business or Islamic financial business within its conventional framework or on a window basis. **The main purpose of s 124 is to formalise the Islamic banking business or Islamic financial business by licensed institutions and to establish a Shariah Advisory Council to advise the bank on Shariah issues relating to Islamic banking business or Islamic financial business.**

The BAFIA shall not apply to an Islamic bank that has been granted a valid licence by Bank Negara Malaysia to carry out Islamic banking business as a totally separate entity subsidiary distinct from its conventional holding banking group.

Islamic banking financing packages are the service offerings and products that an Islamic bank offers. An Islamic Bank is defined under the Islamic Banking Act as *any **company** which carries on Islamic banking business and holds a valid licence; and all the offices and branches in Malaysia of such a bank shall be deemed to be one bank.*

There is no definition of 'banking business' in the IBA except for definition of 'Islamic banking business' which is defined as 'banking business whose aims and operations do not involve any element which is not approved by the religion of Islam'.

This definition may not sufficiently explain the characteristics of banking business itself and as such, we may have to combine the definition of 'banking business' under BAFIA with the definition of Islamic banking business under the IBA. The consequent readings of the two definitions may entail the following understanding:

'Islamic Banking business' thus means 'the business of:

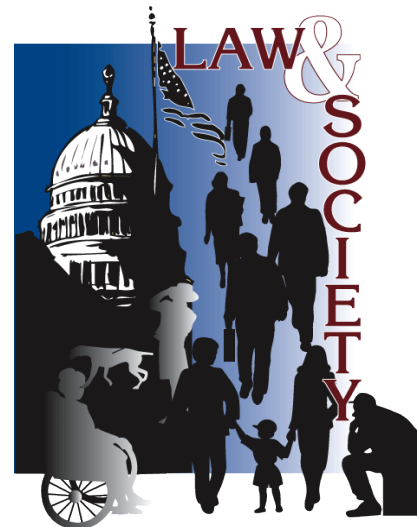
(i) receiving deposits on current account, deposit account, savings account or other similar account;
(ii) paying or collection of cheques drawn by or paid in by customers; and
(iii) provision of finance; or
(iv) such other business as the Bank, with the approval of the Minister may prescribe;

whose aim and operations do not involve any element which is not approved by the Religion of Islam.

The IBA does not elaborate on what is meant by elements which are not approved by the Religion of Islam other than the notes to the IBA which state that '*Element which is not approved by the Religion of Islam' includes charging of interest for facilities (credit) and interest earning deposits*. The notes however are not exclusive and may include other elements yet to be determined by Bank Negara Malaysia or case **law.**

In line with these guiding notes, the Islamic financing products structured by banks carries with it the element of profit in substitution to interest and depositors are rewarded with hibah (gifts) instead of interest.

In the *Guidelines on the Governance of Shariah Committee* issued by the Bank Negara Malaysia, it is stated that Bank Negara Malaysia has amended the Central Bank of Malaysia Act 1958 to enhance the role and functions of its Shariah Advisory Council for Islamic Banking and Takaful ('SAC'). This amendment has accorded the SAC as the sole Shariah authority on Islamic Finance and will be referred to by the court or arbitrator in disputes involving Shariah issues in **Islamic banking, finance and *takaful* issues**. The Shariah bodies in Islamic financial institution will play a complementary role to the SAC of Bank Negara Malaysia.

The civil courts clearly understood the principles of just and equity as expounded by the Shariah and are driven to administer the said principles in Islamic banking and finance cases. In the conduct of Islamic banking cases, the civil courts would be guided by the published Shariah resolutions made by the Shariah Advisory Council of Bank Negara Malaysia and the Shariah Committee of Islamic financial institutions to shed light on Shariah issues presented to the court. The Shariah Resolutions are applicable to all Islamic financial institutions regulated and supervised by Bank Negara Malaysia and are part of the BAFIA rules and regulations according to s 126 of the BAFIA and s 53 of the IBA.

It has been a long established principle since the Court of Appeal decision in *Ramah v Laton* that Islamic **law** is not foreign **law** but it is the **law** of the land and as such it is the duty of the courts to declare and apply the **law.** In reinforcing this principle, the court held that it is not competent for the courts to call expert opinion on Islamic **law.** In our present case however, since there are statutory provisions for the establishment of a body to provide Resolutions on Shariah banking and finance issues, the civil courts would be best guided by the expert advice of the Shariah Advisory Council of Bank Negara and the Shariah Committee of Islamic financial institutions.

The global Islamic banking industry owes its foundation to the team of Malaysian bankers and Shariah scholars. Their efforts have been documented for perpetuity in the report written for publication by the Islamic Development Bank in 1989 outlining in detail the early progress of the Malaysian team in the preparatory work for the setting up of the Islamic Development Bank in Jeddah in the year 1974. The first preparatory committee for the set up was born in an office located in the Dewan Bahasa Building in Kuala Lumpur with advances for expenses made by the Government of Malaysia for the sum of US$ 250,000. Among the experts named in the report were Dr Rais Saniman from Bank Bumiputra Malaysia Bhd (as it was then known) and Tan Sri Dato' Dr Abdul Aziz Zain, the legal expert entrusted with the task of drafting the articles of agreement of the Islamic Development Bank and the regulations pertinent thereto. Until today, the framework for these remains a source of reference and a working model for Islamic banking and financial institutions of international jurisdiction.

When considering issues on Shariah, it is essential for the person so entrusted with the task to be well versed in the knowledge of Shariah or at the very least seek the opinions and advice of those in possession of Shariah knowledge. It is indeed a great responsibility that one undertakes in presenting Shariah issues and in the dispensation of decisions which should reflect an equitable solution.

In *Surah al-Nisa*':59, Allah exhorts man to obey Him, His Messenger and those charged with authority.

The people '*charged with authority*' in the present context, are those who are recognised as experts and knowledgeable in Shariah including issues on Islamic banking and finance.

Islamic Banking